

**Statement of Franklin Templeton in Support of Symposium
Regarding Alternative Apportionment for Mutual Fund Service Providers**

Executive Summary:

The generic allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act (“UDIPTA”) purport to present a one-size-fits-all method of taxation of businesses in different industries. But when the generic method is applied to the mutual fund industry in particular, it does not produce a tax result that accurately and fairly represents a mutual fund service provider’s business activity in California. The FTB has recognized this inequity and in recent years has approved several petitions from mutual fund service providers for alternative apportionment under Section 25137.

The use of the generic “cost of performance” method for mutual fund service providers presents the following drawbacks:

1. Inequitably inflates taxable income in the home-state from sales elsewhere.

The generic method is intended to tax a business based on its income-producing assets and activities in the state. It takes into account the property, payroll, and sales activity of a business in the state. The generic method taxes sales based on the costs associated with generating the sales activity. For intangible property, including mutual fund service transactions, sales are apportioned based on the location of the mutual fund service provider. In so doing, the sales factor replicates the property and payroll factors, giving disproportionate weight to the location of the taxpayer in determining its tax liability.

2. Violates the essential principle that a tax system in apportioning sales should reflect the market for goods and services.

Giving disproportionate weight to the location of the taxpayer in apportioning sales undermines the purpose of the sales factor. The sales factor is designed to give weight to the taxpayer’s marketplace for its goods and services. The sales factor adds balance to the apportionment formula. The earnings of mutual fund service companies depend directly on the relationship between the investor and the service provider. The tax system should reflect the reality and importance of this fact.

3. Discriminates against in-state mutual fund service providers.

The cost of performance rule duplicates a mutual fund service provider’s property and payroll factors and effectively punishes California-based fund companies for establishing their headquarters in this state. Moreover, all of the other major mutual fund states, including New York and New Jersey, have rejected the cost of

performance rule and have adopted the shareholder-residency rule. Under the current national regulatory regime, California-based mutual fund companies have a disproportionately high tax burden in California while out-of-state companies are able to eliminate or substantially reduce their California tax burden through the use of the cost of performance rule.

Given the serious drawbacks associated with applying the generic method to mutual fund service providers, there is a pressing need to develop an alternative apportionment method specific to the mutual fund industry. The current practice where mutual fund service providers must bring a petition for alternative treatment on an ad hoc basis and the FTB must consider each petition individually has drawbacks as well in that it may lead to inconsistent treatment of taxpayers and is an inefficient business practice for all parties.

An alternative apportionment method is needed to eliminate or mitigate these drawbacks. We strongly support the recommendation for a symposium to vet this most important sales factor issue and to consider a host of other issues relevant to the apportionment of income of mutual fund service providers.

Detailed Statement in Support of a Symposium to Study a Proposal for a Regulation for Alternative Apportionment for Mutual Fund Service Providers

- I. Franklin Templeton Investments ("Franklin") provides investment management, distribution, transfer agency and related services for the Franklin, Templeton and Mutual Series mutual funds. Franklin is headquartered in San Mateo, California and employs more than 2,500 individuals in this state. As of July 31, 2005, Franklin managed more than \$438 billion in assets. Franklin is the largest sponsor of California municipal bond funds and manages bond funds holding roughly one-third of the municipal bonds issued in California.
- II. Mutual Fund Businesses are Highly Regulated and Market or Shareholder Driven.
 - a. Mutual Fund Service Providers are subject to regulation by a variety of federal and state agencies including the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and multiple state regulatory bodies. They are subject to regulation under the Investment Company Act of 1940, the Securities Act of 1933, the Securities and Exchange Act of 1934 and the Investment Advisors Act of 1940, as well as separate investment and securities laws and regulations in many of the larger states. This diverse and complex regulatory environment essentially compels mutual fund service companies to operate as separate entities with distinct functional operations.
 - b. A Mutual Fund Service Provider's ability to earn revenues depends on its ability to attract and retain customers (i.e. investors) who want that service provider to manage their investment assets, administer their accounts or provide transfer agency services. This factor is true whether services are provided directly to the public or through brokers and other investment professionals. Service fees for investment management, mutual fund administration, transfer and share distribution services are all based on the value of assets under management, the value of the initial investment or some other investor related measure. In every instance, earnings depend directly on the relationship between the investor and the Mutual Fund Service Provider.

III. California's Apportionment Law.

- a. California's standard apportionment formula determines the income apportionable to California for tax purposes by multiplying the income of the unitary business by a fraction, the numerator of which is the total of the property, payroll and sales (times 2) factors, and the denominator which is 4. (Cal. Rev. & Tax. Code, § 25128.)
- b. The sales factor is computed by dividing sales in California by sales in all states. (Cal. Rev. & Tax. Code, § 25134.) The sales factor serves two distinct roles in the context of the overall apportionment formula:
 - i. The sales factor is designed to give weight in the overall apportionment factor to the States in which the taxpayer markets its goods. (Jerome Hellerstein and Walter Hellerstein, *State and Local Taxation*, 2d Ed. 1993, p. 8-41.)
 - ii. The sales factor adds balance to the apportionment formula. Lacking a meaningful market state factor, all revenues are attributable to the location of a company's offices and manufacturing facilities. (Altman and Keesling, *Allocation of Income in State Taxation* (Chicago, Commerce Clearing House, Inc., 2d Ed., 1950).)
- c. California's sales factor is based on the Uniform Division of Income for Tax Purposes Act (UDITPA) rule: cost of performance. Sales are apportioned within and without the state based on the location of the services generating sales income.
 - i. The sales factor for **tangible property** is determined by the location of destination of the sales. (Cal. Rev. & Tax. Code, § 25135.)
 - ii. The sales factor for **intangible property** is determined based on the location of the greater portion of the income producing activity. (Cal. Rev. & Tax. Code, § 25136.) For service-based taxpayers, the sales factor often replicates the property and payroll factors and does not reflect the markets for the taxpayer services. In the mutual fund service business, sales are typically receipts from service fees earned under contracts with mutual funds for the provision of services to those funds.
- d. **Relief from Distortion** – If the standard apportionment formula does not fairly reflect the extent of the taxpayer's business activity in California, the taxpayer may petition for or the Franchise Tax Board may require separate accounting, exclusion of one or more factors,

inclusion or one or more additional factors or any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Cal. Rev. & Tax. Code, § 25137.)

- e. **Mutual Fund Apportionment Rules in Other States:** Currently 12 other states use shareholder-based apportionment formulas for Mutual Fund Service Providers like Franklin. Not coincidentally, those states also host the largest of the fund companies in the United States.

IV. Support for a Symposium to Study a Proposed Regulation to Adopt Shareholder-Residency Apportionment for Receipts in California.

- a. The cost of performance rule as applied to mutual fund service fees (receipts) does not reflect the market for the services that are performed that generate these fees. Instead, the rule merely duplicates a Mutual Fund Service Provider's property and payroll factors and effectively punishes California-based fund companies for establishing their headquarters in this state.
- b. Other states have adopted shareholder-residency apportionment laws for Mutual Fund Service companies that put California-based companies at a significant competitive disadvantage for two reasons:
 - i. The cost of performance rule does not require non-California based fund companies to apportion income to California based on receipts from California shareholders or investors. These companies apportion their income based on property, payroll and a receipts factor that mimics their property and payroll, effectively escaping tax on income earned from California taxpayers, and
 - ii. California-based mutual fund companies inequitably must apportion all of their receipts based on property, payroll and a receipts factor that mimics property and payroll and fails to account for the mutual fund marketplace. Even though California-based companies earn their income from markets outside California, those markets are not considered in the determination of the sales factor under the cost of performance rule.
- c. **Franklin supports the efforts of the Franchise Tax Board to hold a symposium on this subject to bring fairness and a level playing field into the taxation of Mutual Fund Service Providers in California.**